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Schroders

Economic and Strategy Viewpoint

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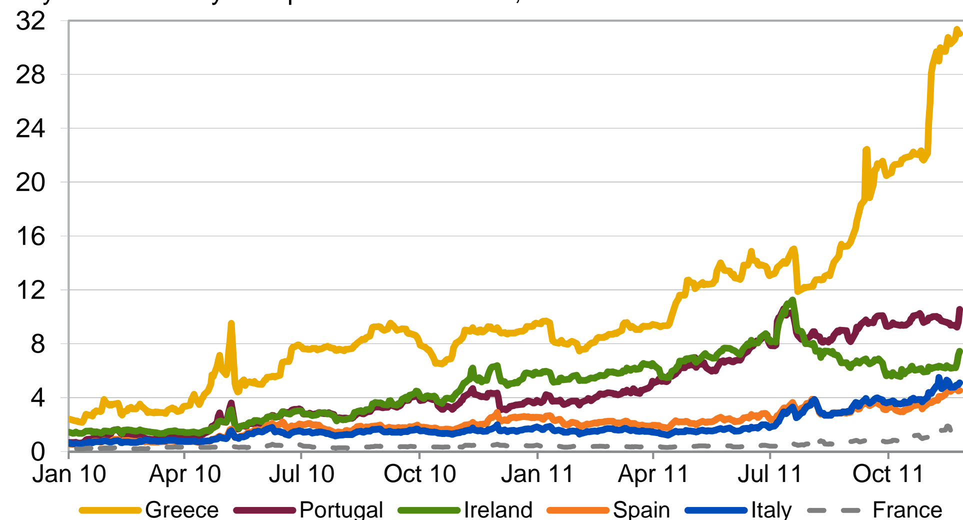
Global: Growth downgraded - no more muddle through

- **We have cut our forecasts for global growth in 2012 from 3.4% to 1.8% largely as a result of the deterioration in the Eurozone where we now expect an outright recession. The rest of the world is affected through weaker trade, a withdrawal of credit by European banks and the adverse effect on business confidence. The unravelling of the Brussels agreement and spread of contagion to the bond markets of Italy and Spain has changed the scale of the problem. Muddle through is no longer the most likely path.**
- **For the Eurozone, we are assuming that Germany relents and allows the European Central Bank (ECB) to implement Quantitative Easing (QE), but only come after the economic situation has become worse and at a price. Consequently we do not expect the ECB to act until next spring, when it should be clear that the Eurozone is in recession, and that there are greater controls over fiscal policy by the EU in the peripheral economies. Should there be no agreement on QE by the ECB, we believe markets should prepare for a possible break up of the single currency - one of our alternative scenarios.**
- **For the US, we have cut growth from 2.4% to 1.6% and again politics plays a role as in addition to the drag from the Eurozone, we do not see Congress allowing much extension of this year's fiscal stimulus. In response we expect the Federal Reserve to launch a third round of QE. This means that both the ECB and Fed could be printing money by spring 2012.**

Europe: To little, too late

- **Early warning signals are ringing loud and clear. The Eurozone is on the verge of a credit crunch. We describe our five stylised stages of a credit crunch and explain why we think the impact on the real economy is likely to be felt in 2012.**
- **Once the credit crunch starts to bite, we expect to see a serious recession in the monetary union, which in-turn will cause a feedback loop on the banking system. However, we are not forecasting a recession that is as deep as that of 2008/09. Nevertheless, the UK is likely to follow the Eurozone into recession, which is likely to prompt at least one more round of QE in 2012.**

Chart: Peripheral bond spreads rising



Thompson Datastream, updated 28 November 2011.

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Global

Global: Growth downgraded - no more muddle through

Brussels agreement offered hope but is now unravelling

At the end of October we allowed ourselves a sigh of relief as the Brussels summit appeared to deliver a sustainable way forward for the Eurozone. Plans to bolster the European Financial Stability Facility (EFSF) bail-out fund and write down Greek debt matched the requirements of many investors. Since then though, prospects have deteriorated: the then Greek Prime Minister Papendreou called for a domestic referendum on the deal, there followed a confrontation with Chancellor Merkel and President Sarkozy in which it was suggested that the referendum be held on whether Greece wished to stay in the Euro. The referendum was withdrawn and subsequently Papendreou stepped down in favour of a coalition government.

At a chaotic G20 meeting in Cannes, it became clear that no external support for the EFSF would be forthcoming with China indicating that the Europeans might sort out their own problems before asking the rest of the world to help.

As contagion spreads through Euro bond markets

By now contagion had spread through the Euro bond markets with spreads on Italy widening and yields rising to an unsustainable 7%. President Berlusconi departed to be replaced by a "technocrat" government led by Mario Monti. Spreads have remained wide and contagion has spread to what had previously been considered core countries like France. Even Germany has experienced the ignominy of a failed Bund auction. Effectively we now have a buyers strike in the Eurozone bond markets and it has been left to the ECB to support prices through its Securities and Markets Programme (SMP).

Not all blame should lie at the door of the Greek or Italian governments. For example, by demanding that banks raise their capital ratios, the Brussels measures added to the credit crunch in Europe as banks have responded by accelerating de-leveraging. The decision to make the 50% haircut on Greek debt "voluntary", so as not to trigger Credit Default Swaps (CDS) payments, may have contributed to the sell off in Italy and elsewhere as investors questioned the value of their insurance.

The crisis has entered a new phase where external help or QE from the ECB is needed

The bottom line though is that the crisis has escalated: Italy is the third largest economy in the Eurozone, a member of the G7 and with public debt to GDP of 121%, has one of the largest bond markets in the world. Yields of 7% are clearly unsustainable in a country with a growth rate of 2% at best. It is clear that the Eurozone does not have the resources to rescue Italy in the way it has supported Portugal, Ireland and Greece. The EFSF currently holds €250 billion, whilst Italy's funding needs for 2012 are €275 billion according to Bloomberg.

Clearly, there can be no more ‘muddle through’ as the scale of the problem is too great. Many commentators have responded by calling for the ECB to begin QE, in other words printing money to drive down peripheral bond yields and put countries funding back on a sustainable footing.

QE from the ECB would work by driving down yields, but will need to overcome German objections

This may well be the ultimate solution, but in our view it is some way off from being acceptable. Markets are now focussed on the stand off between Germany and France over the role of the ECB with the latter and others pushing for the central bank to follow its counterparts in the US and UK by adopting QE. Germany is opposed to such a move as it brings memories of the hyperinflation of the 1920's and it would be seen as the end for any hopes of future fiscal discipline in the region. Angela Merkel has responded to calls for a greater role for the ECB by saying "If politicians believe the ECB can solve the problem of the Euro's weakness, then they are trying to convince themselves of something that will not happen".

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If we rule out QE the options are limited. The main hope would be that the EFSF is increased to the €1 trillion promised at Brussels, the IMF may also have to get involved with a support package[1]. If it is possible to provide a backstop to Italy and others then market confidence might return and we could move back onto a virtuous circle of falling yields and growing confidence.

It needs to get worse before we see a change of tack from Germany

Unfortunately there is little sign of this happening at present which leaves the other, and far less palatable option of default by Italy and those who can no longer sustainably fund themselves at current borrowing rates. Such a move would destroy the banks who hold much of the paper, thus pushing the region into a deeper recession.

In putting together our forecasts, we have attempted to trace out a plausible sequence of events which balances politics and economic developments. We assume that Germany will relent and allow QE, but not until the situation has deteriorated further. Growth is already falling in the Eurozone and we believe the region may already be in recession.

We assume that the pressure builds into 2012 and that Germany changes tack in the spring of next year, after another quarter of falling Eurozone GDP, but also markets attacking French soverign bonds for their indirect expsosure to peripheral debt through French banks. The yield on French government bonds has already been rising in recent months (see chart on front page). France may lose its 'AAA' rating as a result of poor market dymanics, at which point, is likely to finally force Germany to accept the need for QE. In return the IMF is brought in to support Italy and monitor fiscal developments. Treaty changes may be needed but Germany's price for relenting on QE is greater surveillance and power over government budgets across the Eurozone.

Rest of the world suffers through reduced trade and finance

The change of policy comes too late to prevent a fall in Eurozone GDP of 1.8% in 2012, but we should get some stability by the end of the year. As a result of the Eurozone recession we have cut growth elsewhere. The two channels are trade and finance. On the trade side, the rest of Europe is hit hardest through reduced exports whilst beyond the continent, Asia is worst affected (chart 1 on next page). Financial links have a similar effect as Eurozone banks retrench further particularly in Eastern Europe. For the UK where growth is already weak, the Eurozone crisis is expected to tip the economy into a significant recession.

Business confidence is also likely to take a hit resulting in weaker spend

The US has a relatively low trade exposure as a share of total GDP to the Eurozone. However, this understates its importance. Financial links are strong, but perhaps more importantly is the effect of the crisis on business confidence. Business spending is important in our forecast with capital expenditure expected to continue to gather pace in 2012, however if corporates decide they do not like the outlook, then we could see a pause or even cutbacks.

[1] See Schroders Quickview: *"Options for Italy and the Eurozone."*

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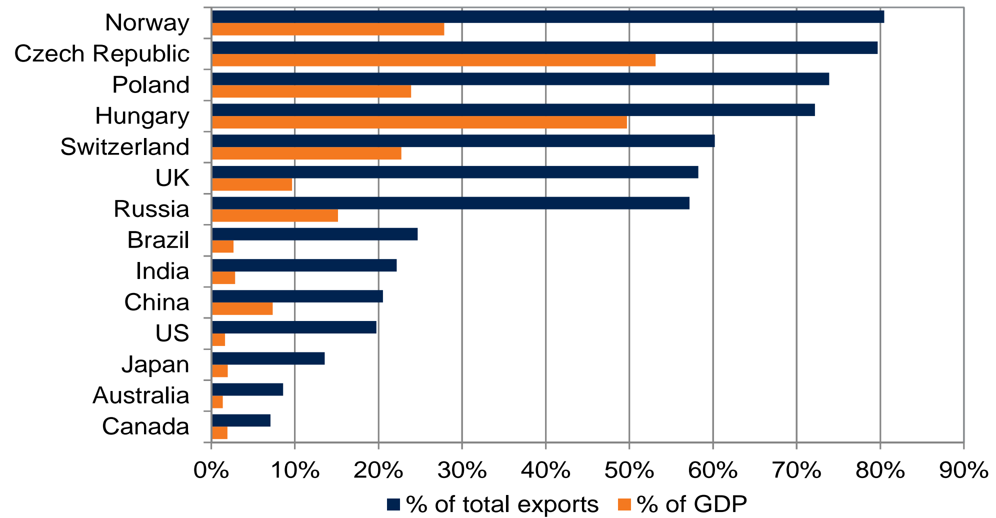
Chart 1: Trade links with the Euro area



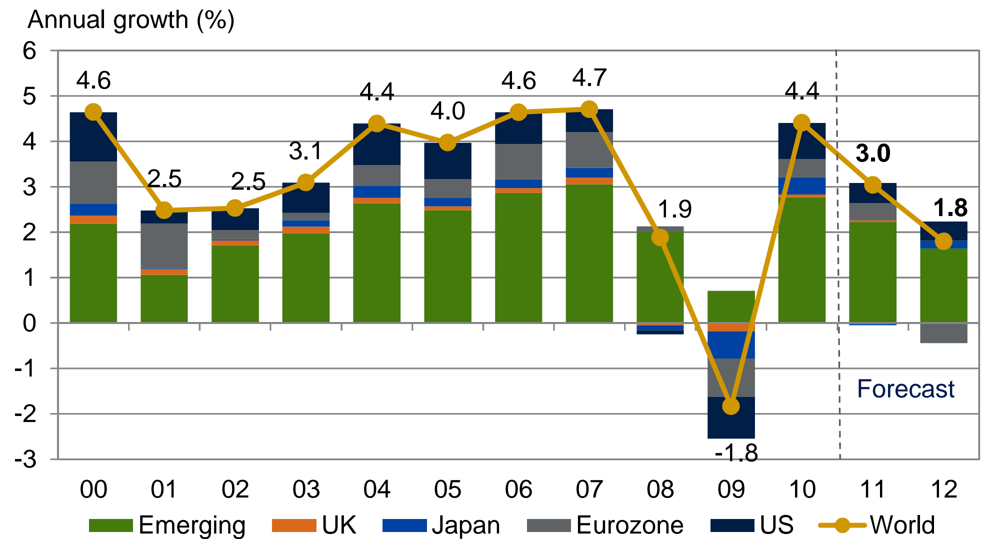
Source: IMF Direction of Trade (DOT) database. Average between 2006-10. Updated 28/10/2011.

Like the Eurozone, we have had to make an assumption about politics in the US. The failure of the "super committee" has no direct impact on 2012, but it has made us reassess the likelihood of President Obama being able to extend tax cuts on payrolls and benefits to the unemployed. Some of his American Jobs Act will pass, but not much leaving the US facing a fiscal drag of some 1 to 1.5% next year. Overall, we have cut our US growth forecast from 2.4% to 1.6% for 2012. As a consequence, we now expect the Fed to embark on QE3 next year. This means that both the ECB and Fed could be printing money by Spring 2012.

Global growth for 2012 downgraded from 3.4% to 1.8%

Taking the regional forecasts together, we have cut our global growth forecast from 3.4% to 1.8% for 2012 as a whole, with most of the drag coming from the European region. The US avoids a technical recession, while a slowdown in global trade helps cool the emerging markets (see chart 2 below).

Chart 2: Schroders global GDP growth forecast



Source: Schroders. Updated 23/11/2011.

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Scenarios

The two risk scenarios we have for next year are:

- Muddle through where politicians do get their act together and markets take a more benign view of Euro debt, and
- Eurozone break-up where either several weaker countries leave or Germany departs from the single currency.

For full details see tables at the back of this document.

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Europe

Europe: Too little, too late

The credit crunch has begun. As described in the Global section of this note, outlook for Europe has shifted to a more negative scenario thanks to the failure of politicians to keep investors on side. Now that Italy and some would argue Spain have reached crisis point, there is a distinct sense of bewilderment in markets as to how the Eurozone can conjure up its next solution without finally resorting to monetising sovereign debt.

The credit crunch is underway as politicians have done too little, too late

Too little have been the solutions offered so far, which have unravelled at an alarming pace. The plan to boost the effectiveness of the EFSF through creating a special purpose vehicle is in tatters as China was reluctant to sign up, while the plan to turn the fund into an insurance scheme is already behind market pricing of expected losses.

Our view is that the ultimate solution will be unsterilised quantitative easing to backstop peripheral government bonds at a specific price or yield, with unlimited firepower. Unfortunately, due to the opposition of fiscal hard-liners like Germany, Austria and the Netherlands, the measures may only arrive once after a significant amount of pain not only to the periphery, but also to the core countries - too late.

We have outlined the five (stylised) stages of a credit crunch, and we believe we have seen evidence of the first three in financial markets. The final two are likely to play out in 2012.

Stage one: Assets turn bad

The start of the credit crunch has been caused by the losses associated with peripheral sovereign debt…

In the run up to the 2008 credit crunch, a number of assets - but mainly US Asset Backed Securities (ABS) linked to the sinking property market - began to underperform causing serious losses through the US and global banking industry. Prices fell and losses escalated as investors lost confidence in these products as they learnt of the lack of transparency involved in the counterparty risk.

Today, the focus is on the value of government bonds and as the chart on the front of this publication shows, the rise in government bond yields in the periphery is a resounding vote of no confidence from investors. The problem is that like US banks and ABS in 2008, European banks are awash with government debt. Worse still as they are not only encouraged, but often required by their own national regulators to hold a significant amount of government debt - after all, a nation's government debt is supposed to offer the closest things to a risk free rate of return.

As the price of these bonds fall, banks are being forced to make provisions for potential losses. Up until now, the European Banking Authority (EBA) has only just started to consider scenarios where Italy and Spain may restructure their debt as part of the next European wide banking stress test. An omission that is has been widely derided for.

Identifying the potential size of the eventual losses is the first step to fixing the banking system. Part of the Brussels agreement on the 27th of October was that banks would be asked to meet a Tier 1 capital ratio of 9% by June 2012. On the one hand, identifying the problem is the first stage of solving it, on the other hand, the cure of deleveraging might kill the patient. We will return to this point later.

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Stage two: Banks stop lending to each other

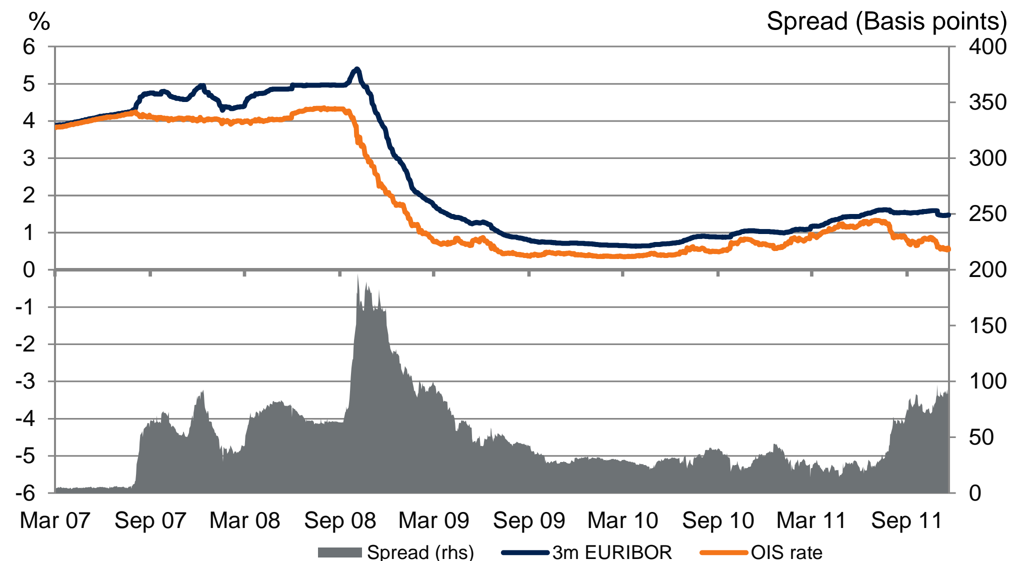
…which is causing banks to reduce their exposure towards other banks, hurting short-term interbank lending

As losses begin to escalate, it is natural for investors, including banks, to review their counter-party risk. This was one of the key drivers of the credit crunch in 2008, especially in the run-up to, and immediately following the collapse of Lehman Brothers. Banks were in panic. Nobody knew which institutions had exposure to Lehman Brothers, and so there was no way to be sure that any given institution an investor might be dealing with was not sitting on potentially crippling losses.

It took government intervention, two stress tests and huge recapitalisation before banks were willing to trust one another.

In the intermittent period, the cost of short-term wholesale funding rocketed versus the cost of an overnight loan. As chart 3 shows, the spread in Europe between the Overnight Interest rate Swap (OIS) and the 3-month European Interbank Offer Rate (EURIBOR) had almost reached 200 basis points within weeks of the collapse of Lehman's in September 2008. It took a year before spreads fell back to what we can now think of as the new norm.

Chart 3: European interbank lending



Source: Thompson Datastream, Schroders. Updated 26 October 2011.

However, since around the time European politicians were on their summer holidays in August of this year, spreads have been rising once again. Stage two appears to be underway.

Stage three: Investors stop lending to banks

Short-term liquidity problems have not gone unnoticed…

If banks refuse to lend to each other, then there is clearly a problem. This is quickly picked up by real money investors who then choose to reduce their exposure relative to the non-financial sector. This was certainly the case in 2008 which caused the cost of borrowing for financial companies through credit markets to rise markedly versus other sectors. The same now appears to be happening again (chart 4 on next page).

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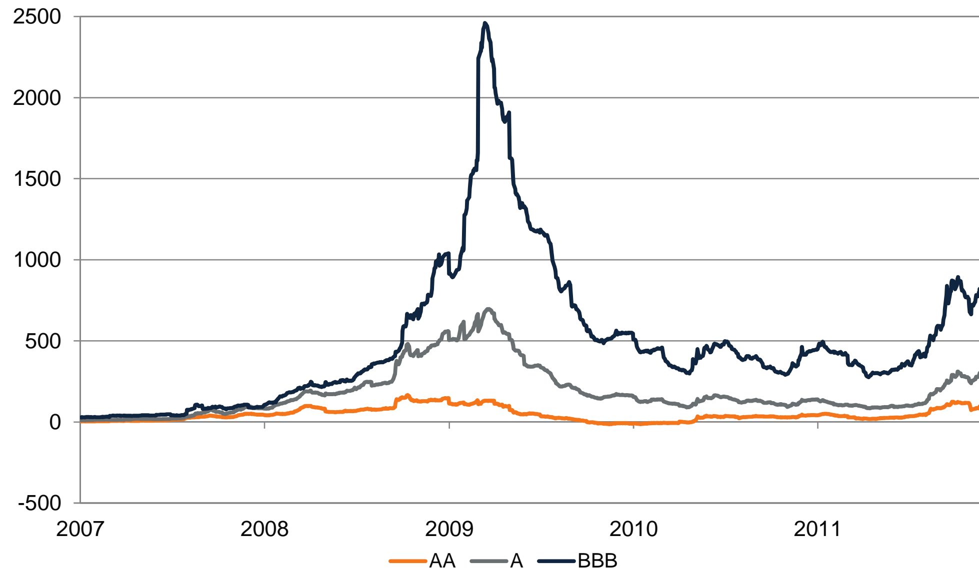
Chart 4: Borrowing premium for financial institutions

… as investors demand more for longer-term funding for banks relative to non-financial sectors…



Source: Thompson Datastream, Schroders. Updated 26 October 2011.

The freezing out from credit markets is more serious than the rise in the cost of interbank borrowing outlined in stage two. This is the channel that banks rely on for marginal secure long-term funding. It is very difficult to increase the level of consumer or even corporate deposits on a bank's balance sheet in the short-term, but in functioning capital markets, raising capital through the issuance of corporate bonds is vital for banks.

… which is a concern as it appears that there is a significant funding gap appearing for this year.

More worryingly, according to the Financial Times, European banks have only sold $413 billion worth of bonds this year, equivalent to just two-thirds of the $654 billion that is due to be returned to investors in 2011 as debt matures.[2] There are a number of reasons why that number may be so low such as active deleveraging, however, there is clearly a stand-off between banks who are unwilling to borrow given such high marking interest rates, and investors who are unwilling to fund the banks given the uncertainty surrounding the sovereign debt crisis.

Of course, we stress that not all banks are in such bad shape, though when we see a bank like Dexia who passed all the EBA's stress tests with flying colours end up being nationalised within months after those tests, we fear that such uncertainty can only inflame the situation.

Stage four: Banks stop lending to the real economy

At some stage, banks will need to recapitalise their balance sheets, which is likely to mean reduced lending to the real economy…

If the level of savings and deposits are stable, and if banks cannot borrow, then they cannot lend. This would lead to a fall in new lending to not only households, but also to businesses. Worse still, if the banks are having to make provisions for losses, or being forced to hold more core capital (as is the case now), then they may even seek to reduce the size of their balance sheets.

The Brussels agreement tells banks that they must try to boost their Tier 1 capital ratios but without reducing lending to their own economies. Banks are being told to look at raising more capital by issuing equities, though without offering deep discounts relative to book values, banks are likely to struggle to attract investors given current market conditions.

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[2] Europe's banks feel funding Squeeze, Financial Times, 27/11/2011.

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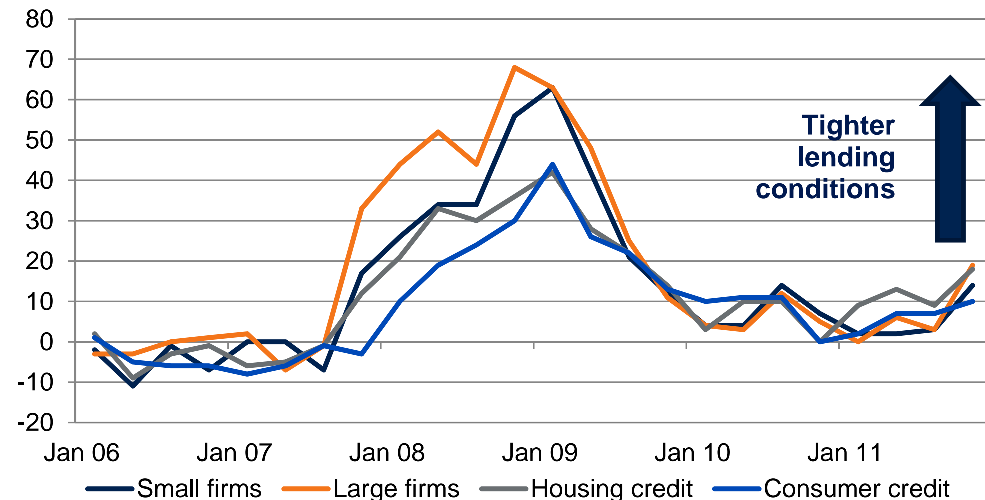
Failing the above, banks are being advised to sell their overseas assets. We have already seen some Portuguese and Spanish banks selling their loan books in Brazil and Mexico in order to reduce their holdings of risky assets. The irony is that the assets being sold are likely to also be the most profitable part of their loan books. Profits required not only to be recycled into more capital (by retention), but also to attract investors. Asking the banks to deleverage and in turn reducing their profitability can only make banks even less attractive to investors - risking the cure killing the patient.

…though we appear to only be at the early stages of the deleveraging process…

So far, we have only seen small signs of lending conditions becoming tighter in the Eurozone. The latest reading from the European Central Bank's survey of lending conditions shows a rise in reported net tighter lending conditions across all the types of lending. Indeed, lending to large firms is at its worst since June 2009 (see chart 5).

Chart 5: Eurozone lending conditions



Source: European Central Bank, Thompson Datastream, Schroders. Updated 28 November 2011.

Stage five: Recession and the feedback loop

…however, once lending starts to be scaled back, a recession is very likely…

As the banking system begins to reduce lending to households and businesses, the lack of new credit causes consumption and investment to slow - weakening domestic demand. If the fall in lending is significant enough, it could lead to a recession, causing a fall in wages and higher unemployment.

In 2008, reduced lending arguably hit mortgage borrowers first. The lack of mortgage availability restricted access to the housing market for new borrowers and effectively cut off new demand. The lack of new demand in combination with rising unemployment caused house prices to fall further, which in turn lead to more losses for banks on their loan books, causing banks to reduce lending further - a feedback loop.

…which in turn could cause more banking losses, and more cuts in lending, creating a feedback loop.

This time, the feedback loop is happening through the aggressive nature of fiscal policy which is attempting to get ahead of the crisis in market confidence. However, as we highlighted in last month's Economic and Strategy Viewpoint, the huge effort made in Greece to raise taxes and cut spending has actually caused the deficit to rise rather than fall.

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Going forward, we expect not only to see the austerity measures currently being unveiled to contribute to the Eurozone recession we are forecasting, but also the impact of the credit crunch to ensure that the recession is deeper than most are currently forecasting. Indeed, our forecast for -1.8% GDP growth in 2012 represents a 3% fall in output from peak to trough. This is more bearish than any of the individual forecasters contributing to the Consensus Economics, or Bloomberg surveys of forecasters.

Not as bad as Lehman, if the ECB intervenes

Though we expect a serious recession in the Eurozone, we believe it will be smaller than 2008…

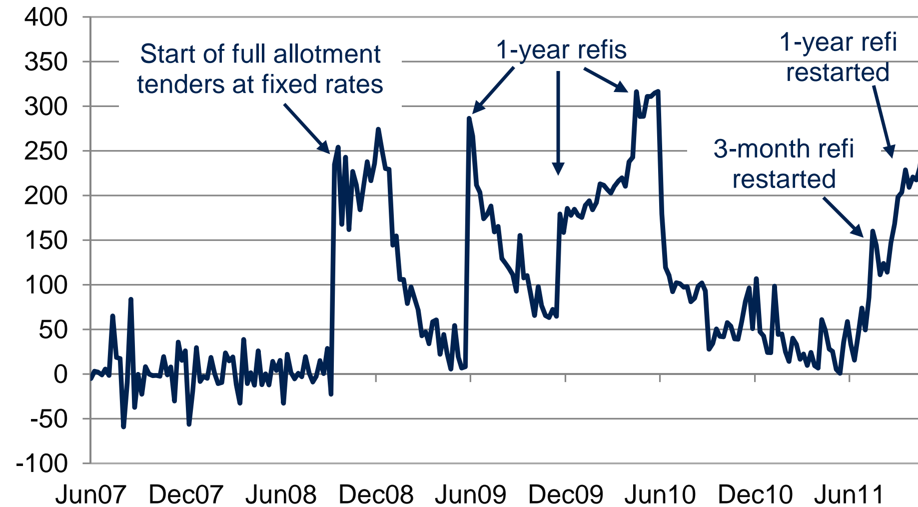
Though we have a bearish forecast for the Eurozone, we do not believe it will be as bad as 2008. Eurozone output fell by 5.4% between the start of 2008 and the first half of 2009, which is a greater than the 3% fall we are forecasting for 2012.

Unlike the Lehman Brothers crisis, there is more information available today about which banks hold which Euro government bonds. Moreover, more information is being made available about banking linkages and the exposure to other Eurozone banks. This type of information enables investors to make more informed investment decisions than in 2008.

Moreover, the ECB has been heavily involved in supporting the secondary Italian and Spanish government bond markets. Total purchases of government bonds surpassed the €200 billion mark this month, and with another €265 billion of banking reserves being held at the ECB, liquidity from the central bank has been far more timely on this occasion (see chart 6).

…thanks to action taken so far by the ECB, and the information available about who holds peripheral debt.

Chart 6: Excess banking reserves held at the ECB (€Bn)



Source: European Central Bank. Updated 28 November 2011.

We expect the ECB to cut interest rates in December by another 25 basis points, taking the main refinancing rate back to its crisis trough of 1%. However, without the threat of fully unsterilised QE, we struggle to see how a break-up of the Eurozone can be avoided.

New forecast

Table 1 (next page) provides details of the changes to the European forecast for growth and inflation. Of the big four, the deepest recessions are expected in Italy and Spain, though the downgrades are significant across the region.

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Table 1: Schroders European GDP and inflation forecast

	2011				2012			
	Growth		Inflation		Growth		Inflation	
	New	Prev.	New	Prev.	New	Prev.	New	Prev.
Eurozone	1.6	*1.7*	2.6	*2.8*	-1.8	*1.0*	1.6	*2.2*
Germany	3.0	*3.0*	2.5	*2.5*	-1.0	*1.6*	1.6	*2.1*
France	1.4	*1.8*	2.2	*2.2*	-1.6	*1.2*	1.5	*1.9*
Spain	0.7	*0.8*	3.2	*3.3*	-2.1	*0.3*	1.7	*1.8*
Italy	0.5	*0.9*	2.5	*2.5*	-3.0	*-0.3*	2.0	*2.5*
UK	0.9	*1.3*	4.5	*4.5*	-0.4	*1.9*	2.0	*2.6*

Source: Schroders. Updated 24 November 2011.

Given its proximity, the UK will not be able to avoid a recession in 2012…

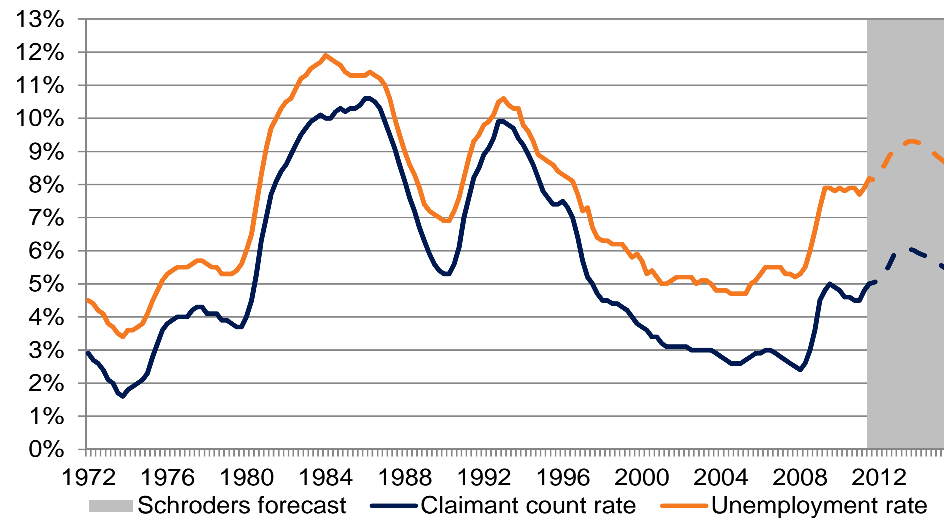
Given the close proximity of the UK, the trade links and the banking exposure to mainland Europe, the UK will be unable to avoid a recession. We expect UK GDP growth to fall by 1% from peak to trough over the first half of 2012, following which the positive impact of the London 2012 Olympics should lift the economy out of recession. This is a one-off benefit which had reduced growth earlier this year, and so we then expect growth to remain fairly weak from Q4 2012 onwards.

At the time of writing, the independent Office for Budgetary Responsibility (OBR) downgraded its forecast for UK and Eurozone growth to +0.7% and +0.5% for 2012 respectively. Though the OBR's forecast is broadly in-line with the consensus, clearly the forecast is more optimistic than our own.

Given the recession we are forecasting, we also expect UK unemployment to rise substantially over the coming two years (chart 7 below). Due to the automatic stabilisers in place, higher unemployment is likely to mean that the UK government will borrow considerably more than the OBR's forecast as part of the Chancellor's Autumn Statement.

…which should push the rate of unemployment higher, and cause another overshoot in public borrowing…

Chart 7: Schroders UK unemployment forecast



Source: Office for National Statistics, Schroders. Updated 28 November 2011.

…nevertheless, there is always 'plan B' - more and more QE.

Finally, we expect the Bank of England not only to keep interest rates on hold, but also to announce more QE in February 2012 as the current purchasing plans are concluded. And because we do not believe QE will stop the recession, we are forecasting even more QE later in the year.

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I. Updated forecast tables

Forecast table: Baseline

Real GDP

y/y%	Wt (%)	2010	2011	Consensus	2012	Consensus
US	26.4	3.0	1.7	1.8	1.6	2.1
UK	4.1	1.4	0.9	1.0	-0.4	1.1
Eurozone	23.5	1.7	1.6	1.6	-1.8	0.4
Japan	9.5	4.0	-0.5	-0.4	1.8	2.1
OECD	63.5	2.6	1.3	1.3	0.3	1.4
Emerging*	36.5	7.6	6.1	6.0	4.5	5.5
World	100.0	4.4	3.0	3.0	1.8	2.9

Inflation CPI

y/y%	Wt (%)	2010	2011	Consensus	2012	Consensus
US	26.4	1.6	3.0	3.2	1.7	2.1
UK	4.1	3.3	4.5	4.5	2.0	2.8
Eurozone	23.5	1.6	2.6	2.7	1.6	1.8
Japan	9.5	-0.7	-0.2	-0.3	-0.2	-0.2
OECD	63.5	1.4	2.5	2.6	1.4	1.7
Emerging*	36.5	5.2	6.2	6.0	4.5	5.2
World	100.0	2.8	3.8	3.8	2.5	3.0

* **Emerging markets**: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Slovakia, Romania, Turkey, Ukraine, Bulgaria, Croatia, Estonia, Latvia, Lithuania

Interest rates

%	Wt (%)	Dec-10	Dec-11	Market	Dec-12	Market
US	26.4	0.25	0.25	0.80	0.25	1.92
UK	4.1	0.50	0.50	1.11	0.50	1.35
Eurozone	23.5	1.00	1.00	1.38	1.00	1.19
Japan	9.5	0.10	0.10	0.33	0.10	0.34
OECD	63.5	0.52	0.52	0.96	0.52	1.38

Market data as at 22/11/2011

Key variables

FX	*Current*	Dec-10	Dec-11	y/y%	Dec-12	y/y%
USD/ GBP	*1.56*	1.60	1.55	-3.1	1.45	-6.5
USD/ EUR	*1.35*	1.34	1.30	-3.0	1.15	-11.5
JPY/ USD	*77.0*	83.0	75.0	-9.6	70.0	-6.7
GBP/ EUR	0.86	0.84	0.84	0.1	0.79	-5.4
Brent crude	*108.5*	87.2	107.3	23.1	105.2	-2.0
US output gap %GDP	*-5.5*	-6.4	-5.0		-5.1	
Unemploy. %	*9.1*	9.6	8.9		9.2	

Source: Schroders, Datastream, Consensus Economics, November 2011

Baseline - Eurozone credit crunch, both Fed and ECB embark on QE

- The deteriorating situation in the Eurozone has prompted us to downgrade our global growth forecasts to 1.8% for 2012 (previously 3.4%).
- We are now forecasting a fall in GDP of 1.8% for the Eurozone in 2012 as financing costs in the periphery rise, banks restrict credit and fiscal austerity plans bite. All countries in the region, including Germany, are expected to experience a fall in GDP next year.
- We assume that Germany gives in to Quantitative Easing (QE) by the ECB in return for support and strict IMF fiscal monitoring for Italy. This would occur after two quarters of falling GDP in the region (11q4 and 12q1), which causes Germany to change its stance on QE. ECB purchases help drive down yields in the periphery, but are too late to prevent a further fall in output in Q3. Nonetheless, the action by the ECB restores investor confidence, puts sovereigns back on a sustainable path and holds the Euro together, albeit at a considerably lower level.
- The knock on effect is felt most keenly in the rest of Europe with the UK also dropping back into recession in 2012 as exports fall. UK GDP is now forecast at -0.4% (compared with a previous forecast of 1.5%). The difficult global backdrop is likely to cause businesses to delay capex increases.
- The US is also hit by the loss of Eurozone demand and cut backs by European banks. In addition we see more fiscal tightening in 2012: following the failure of the so called Supercommittee to agree, the probability of Congress approving the President's extension of this year's stimulus is reduced. We have cut our US GDP forecast to 1.6% as a result (previously 2.4%) and now expect the Federal Reserve to start another round of QE in Q2 next year.
- For the emerging markets growth suffers for the same reasons with Eastern Europe hit particularly hard. However, Asia also has strong trade links with the Eurozone and the crisis only reinforces the slowdown which is already underway in China.
- Japan is also affected but is partly insulated by reconstruction spending in 2012.
- The one bright spot in the forecast is a sharp fall in inflation as this year's surge in commodity prices drops out of the indices and weak growth squeezes core prices. Global inflation is forecast to fall from 3.8% this year to 2.5% next - an outcome which should support real incomes and consumption.
- On the policy front, with central banks unable to cut rates further (we assume that the ECB moves back to 1% in December) the Fed, ECB and Bank of England all embark on QE in 2012, as a result we see the USD strengthening in 2012 against GBP and EUR. The JPY is seen as a safe haven and makes new highs.

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Forecast table: Scenario 1 – Muddle through

Real GDP

	Wt (%)	2010	2011	2011q4	2012	2012q4	v.base 2011	v.base 2012
US	26.4	3.0	1.7	1.6	2.6	3.0	0.0	1.0
UK	4.1	1.4	1.0	1.0	1.6	1.9	0.1	2.0
Eurozone	23.5	1.7	1.7	1.3	1.0	1.2	0.1	2.8
Japan	9.5	4.0	-0.4	0.6	2.5	3.0	0.1	0.7
OECD	63.5	2.6	1.4	1.3	1.9	2.2	0.1	1.7
Emerging*	36.5	7.6	6.3	6.2	6.0	6.0	0.2	1.5
World	100.0	4.4	3.2	3.1	3.4	3.6	0.1	1.6

Inflation CPI

	Wt (%)	2010	2011	2011q4	2012	2012q4	2011	2012
US	26.4	1.6	3.0	2.7	2.1	1.9	0.0	0.5
UK	4.1	3.3	4.6	5.0	3.0	2.1	0.1	0.4
Eurozone	23.5	1.6	2.7	2.7	2.0	1.6	0.1	0.4
Japan	9.5	-0.7	-0.2	-0.1	-0.4	-0.7	0.0	-0.2
OECD	63.5	1.4	2.5	2.4	1.8	1.4	0.1	0.3
Emerging*	36.5	5.2	6.0	6.0	3.5	3.5	-0.2	-1.0
World	100.0	2.8	3.8	3.7	2.4	2.2	0.0	-0.1

Interest rates

	Wt (%)	Dec-10	Dec-11	Market	Dec-12	Market	2011	2012
US	26.4	0.25	0.25	0.80	0.25	1.92	0.0	0.0
UK	4.1	0.50	0.50	1.11	0.50	1.35	0.0	0.0
Eurozone	23.5	1.00	1.00	1.38	1.00	1.19	0.0	0.0
Japan	9.5	0.10	0.10	0.33	0.10	0.34	0.0	0.0
OECD	63.5	0.52	0.52	0.96	0.52	1.38	0.0	0.0

Market data as at 22/11/2011

Key variables

FX	Current	Dec-10	Dec-11	y/y %	Dec-12	y/y %
USD/ GBP	1.56	1.60	1.57	-1.9	1.47	-6.4
USD/ EUR	1.35	1.34	1.35	0.7	1.40	3.7
JPY/ USD	76.98	83.0	75.0	-9.6	80.0	6.7
GBP/ EUR	0.86	0.84	0.86	2.7	0.95	10.8
Brent crude	108.5	87.2	112.3	28.8	120.2	7.0
US output gap %GDP	-5.48	-6.4	-6.0		-5.4	
Unemploy. %	9.10	9.6	9.0		7.9	

Source: Schroders, Datastream, Consensus Economics, November 2011

- This scenario is closer to our original baseline where we saw the Eurozone crisis contained with policymakers doing enough to keep markets at bay. Italy changed that so today "muddle through" would mean a rapid move to QE by the ECB, thus easing the sovereign crisis in the Eurozone.
- In addition we would include a beefing up of the EFSF as promised at the Brussels summit and IMF involvement before the end of 2011.
- Outside the Eurozone we would look for the US Congress to agree to the extension of fiscal stimulus into 2012 and for Asian central banks to allow further appreciation in their currencies.
- The result is stronger global growth with the Eurozone avoiding recession and the US maintaining the recent improvement in performance. Emerging markets are also a winner from the better global environment.
- Commodity prices and inflation would be higher, but base effects still mean that headline inflation is lower in 2012 than 2011.
- Despite stronger growth and higher inflation than in the base, the main difference on the policy front is that the Federal Reserve refrains from further QE as unemployment falls back.
- On the currency side the better macro environment should support risk assets resulting in a weaker USD and firmer EUR compared to the base.

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Forecast table: Scenario 2 – Euro break up

Real GDP	Wt (%)	2010	2011	2011q4	2012	2012q4	v.base 2011	v.base 2012
US	26.4	3.0	1.7	1.4	-0.7	-2.6	0.0	-2.4
UK	4.1	1.8	0.8	0.7	-1.5	-1.9	-0.1	-1.1
Eurozone	23.5	1.7	1.6	0.9	-5.7	-11.9	0.0	-3.9
Japan	9.5	4.1	-0.5	0.5	0.3	0.5	0.0	-1.5
OECD	63.5	2.6	1.3	1.0	-2.5	-5.5	0.0	-2.7
Emerging*	36.5	7.6	6.1	6.1	2.5	2.5	0.0	-2.0
World	100.0	4.5	3.0	2.9	-0.7	-2.6	0.0	-2.5

	Wt (%)	2010	2011	2011q4	2012	2012q4	2011	2012
US	26.4	1.6	2.9	2.3	0.7	0.1	0.0	-1.0
UK	4.1	3.3	4.5	3.3	1.4	0.4	0.0	-1.2
Eurozone	23.5	1.6	2.6	2.6	3.4	2.0	0.0	1.8
Japan	9.5	-0.7	-0.2	-0.1	-0.7	-0.7	0.0	-0.5
OECD	63.5	1.4	2.4	2.1	1.5	0.7	0.0	0.1
Emerging*	36.5	5.2	6.2	5.9	2.5	2.0	0.0	-2.0
World	100.0	2.8	3.8	3.5	1.9	1.2	0.0	-0.7

Interest rates	Wt (%)	Dec-10	Dec-11	Market	Dec-12	Market	2011	2012
US	26.4	0.25	0.25	0.80	0.25	1.92	0.0	0.0
UK	4.1	0.50	0.50	1.11	0.50	1.35	0.0	0.0
Eurozone	23.5	1.00	1.00	1.38	1.00	1.19	0.0	0.0
Japan	9.5	0.10	0.10	0.33	0.10	0.34	0.0	0.0
OECD	63.5	0.52	0.52	0.96	0.52	1.38	0.0	0.0

Market data as at 22/11/2011

Key variables

FX	Current	Dec-10	Dec-11	y/y %	Dec-12	y/y %
USD/ GBP	1.56	1.60	1.55	-3.1	1.54	-0.6
USD/ EUR	1.35	1.35	1.30	-3.7	1.18	-9.2
JPY/ USD	76.98	83	74	-10.8	60	-18.9
GBP/ EUR	0.86	0.84	0.84	-0.6	0.77	-8.6
Brent crude	108.47	87.2	97.3	11.6	75.2	-22.8
US output gap %GDP	-5.48	-6.4	-6.2		-8.1	
Unemploy. %	9.10	9.6	9.6		10.5	

Source: Schroders, Datastream, Consensus Economics, November 2011

- In this scenario we assume that Germany holds its line on not allowing QE, resulting in the ECB being unable to cap bond yields in the peripheral Euro markets. Capital flees these economies and, with no strengthened EFSF and the IMF on the sidelines, the result is a series of defaults in Portugal, Ireland, Spain and Italy.
- The resulting collapse in their banking systems and economies and political acrimony between states leads to a withdrawal of the peripheral economies and break-up of the Euro. Alternatively, the break up could come from the top of the system with Germany withdrawing as it sees its vision of a fiscally sound Eurozone fade away as the other members insist on QE.
- In terms of timing we assume this occurs in Q2 next year.
- The creation of new currencies to replace the Euro is likely to result in weaker currencies in the periphery, but a stronger core with the new Deutschmark appreciating sharply.
- Global growth takes a hit as trade and finance dry up with the result that the world economy experiences a deeper recession than in the base, although not as bad as in 2009.
- Inflation in the Eurozone nets out higher than in the base due to the distribution of devaluation/ appreciation (e.g. Italy 9%, Germany 0.6%), overall though global inflation is lower as recession bites and energy prices fall.
- We would see this scenario as being a major deflationary shock for the world economy.
- Expect more QE from the Fed, BoJ and BoE.

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II. Updated forecast charts - Consensus Economics

For the EM, EM Asia and Pacific ex Japan, growth and inflation forecasts are GDP weighted and calculated using Consensus Economics forecasts of individual countries.

Chart A: GDP consensus forecasts

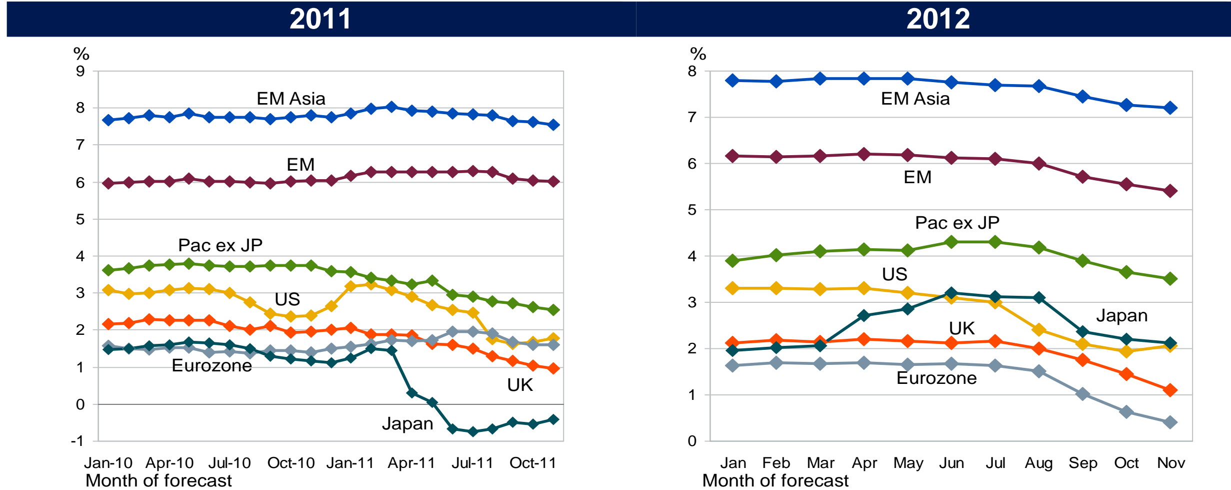
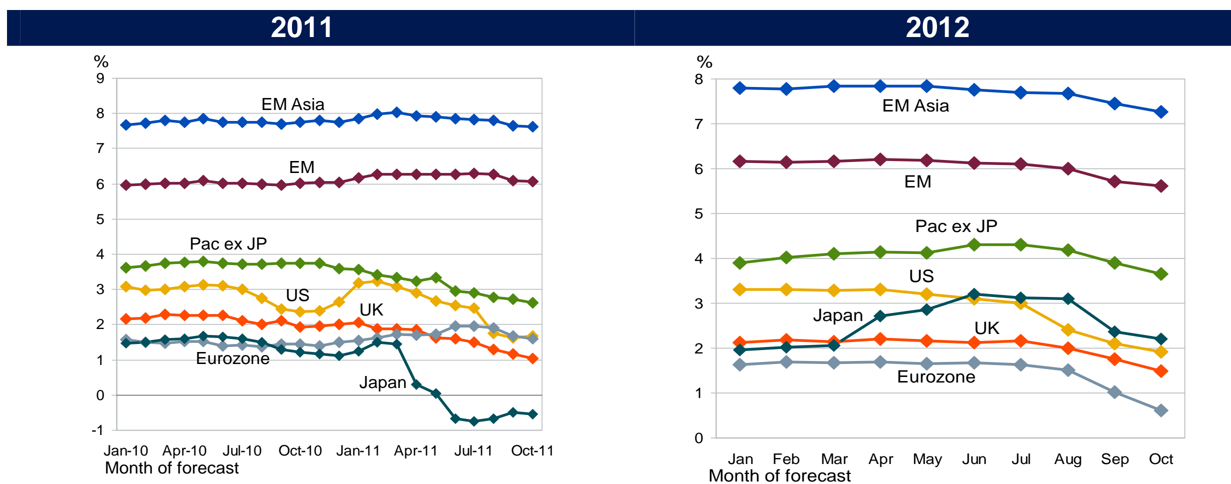


Chart B: Inflation consensus forecasts



Source: Consensus Economics, Schroders, November 2011

Emerging markets: Argentina, Brazil, Chile, Colombia, Mexico, Peru, Venezuela, China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand, South Africa, Russia, Czech Rep., Hungary, Poland, Slovakia, Romania, Turkey, Ukraine

Emerging Asia: China, India, Indonesia, Malaysia, Philippines, South Korea, Taiwan, Thailand

Pacific ex. Japan: Australia, Hong Kong, New Zealand, Singapore

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